SUPREME COURT, U. S.

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JOHN F. DAVIS, CI

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1969

NO. 1130

CAPITAL SOUTHWEST CORPORATION, ET. AL.,
Appellants

v.

ROBERT S. CALVERT, COMPTROLLER OF PUBLIC ACCOUNTS OF THE STATE OF TEXAS, ET AL.,
Appellees

ON APPEAL FROM THE COURT OF CIVIL APPEALS FOR THE THIRD SUPREME JUDICIAL DISTRICT OF TEXAS

MOTION TO DISMISS OR AFFIRM

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Robert S. Calvert, Comptroller of Public Accounts of Texas,
Jesse James, State Treasurer of Texas, and
Crawford C. Martin, Attorney General of Texas.

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MOTION TO DISMISS OR AFFIRM

Appelleees, Robert S. Calvert, Comptroller of Public Accounts of Texas, Jesse James, State Treasurer of Texas, and Crawford C. Martin, Attorney General of Texas, move the Court to dismiss the appeal herein or, in the alternative, to affirm the judgment of the Court of Civil Appeals for the Third Supreme Judicial District of Texas, on the grounds 1) that the appeal does not present a substantial federal question, and 2) that the judgment of the Texas court rests on many adequate non-federal bases.

NATURE AND RESULT OF THE CASE IN THE TEXAS COURTS

The sole issue is the construction of the Texas statute; that issue is whether the three Appellant Corporations, severally, qualified as "mutual investment companies" within the purview of the Texas statute.[1] There was no material conflict or contradiction in the evidence. The decision of the Texas Court is the only decision of any court construing the statute.

Each of the three Appellants filed separate suits in the trial court. Since a common question was presented by these three separate suits, and since much of the evidence on the trial applied to each of the Appellants, the cases were tried jointly and concurrently. The three cases were consolidated into one final judgment in the trial court from which the three Appellants jointly appealed to the Texas Appellate Courts, and have presented their joint appeal to this Honorable Court.

THE TEXAS STATUTE

The Act of the Texas Legislature under consideration[2] reads as follows:

> *"Be it enacted by the Legislature of the State of Texas:*
>
> Section 1. That Article 7094, Revised Civil Statutes of Texas of 1925, as amended, be and the same is hereby amended so as to read hereafter as follows:

---

[1]Article 12.03, Title 122A, Taxation-General, (formerly Art. 7094), Vernon's Texas Civil Statutes, as amended by Acts of 1951, 52nd Leg., Regular Session, Ch. 143, p. 245. Subsequent amendments to this Act are not material to the case at bar.

[2]See footnote 1 at page 2 of this Motion.

"Article 7094

"The franchise tax imposed by this Chapter shall not apply to any insurance company, surety, guaranty or fidelity company, or any transportation company, or to any corporation organized as a terminal corporation not organized for profit and having no income from the business done by it, or to any sleeping, palace car and dining car company now required to pay an annual tax measured by their gross receipts, or to corporations having no capital stock and organized for the exclusive purpose of promoting the public interest of any city or town, or to corporations organized for the purpose of religious worship or for providing places of burial not for private profit, or to corporations organized for the purpose of holding agricultural fairs and encouraging agricultural pursuits, or for strictly educational purposes, or for purely public charity, or to State-chartered building and loan associations, or to any mutual investment company registered under the Federal Investment Company Act of 1940, as from time to time amended, which holds stocks, bonds, or other securities of other companies solely for mutual investment purposes."

"Sec. 2. The fact that the sole source of income of such mutual investment companies is from receipt of dividends or interest on stocks, bonds, or other securities of other corporations (held solely for investment purposes by such mutual investment companies), and the fact that such other corporations already are subject to and pay a franchise tax: that the subjection of such mutual investment companies to a franchise tax in effect taxes the same source twice, as is recognized by the Federal Government in exempting from Federal Income Taxes the income of such mutual investment companies which is distributed to their shareholders; the fact that mutual investment compa-

nies doing business in many other States are granted exemptions from franchise taxes whereas mutual investment companies doing business in the State of Texas are not exempt from franchise taxes, thereby placing the latter companies at an unfair disadvantage with respect to selling its shares to Texas investors; that such mutual investment companies should be encouraged to do business in Texas; that the calendars of both Houses are likely to become crowded; and the further fact that the changes proposed herein need to become effective at the earliest possible time, create an emergency and an imperative public necessity, authorizing the Constitutional Rule requiring bills to be read on three several days in each House be suspended; and said Rule is hereby suspended, and this Act shall take effect and be in force from and after its passage, and it is so enacted."

MODE OF PRESENTATION

This MOTION is presented under THREE POINTS which are as follows:

POINT I

This Honorable Court, and the Circuit Court of Appeals for the Second Circuit, and the Congress of the United States in two separate Acts, all have firmly established that for tax exemption purposes the distinction between mutual and non-mutual organizations is valid under the equal protection clause of the Fourteenth Amendment of the United State Constitution.

This POINT I is presented at pages 5-9 of this MOTION.

POINT II

The purpose of the Texas Statute was to exempt

from its franchise tax the type of corporation designated as, and having the well established characteristics of, a mutual investment company, and which corporation also should qualify under the additional five independent and mandatory requisites of the statute.

This POINT II is presented at pages 9-11 of this MOTION.

POINT III

Requisites Numbers three, four and five of the statute, as enumerated by the Texas Court, were not complied with by any of Appellants. Each is wholly unrelated to whether any Appellant was an open-end or a closed-end company.

This POINT III is presented at pages 11-13 of this MOTION.

POINT I

(Restated)

This Honorable Court, and the Circuit Court of Appeals for the Second Circuit, and the Congress of the United States in two separate Acts, all have firmly established that for tax exemption purposes the distinction between mutual and non-mutual organizations is valid under the equal protection clause of the Fourteenth Amendment of the United State Constitution.

Statement

These Court decisions and the Acts of Congress are established predicates and sufficient to uphold the constitutionality of the Texas statute against the claims of Appellants that the few elements of classification there-

in based upon whether a corporation is an open-end or a closed-end corporation are invalid.

Argument and Authorities

A State may adjust its revenue laws and taxing system in such a way as to favor certain industries or forms of industries; it may exempt from taxation kinds of business which it wishes to promote. *Liggett Co. v. Lee*, 288 U.S. 517, 570 (1933).

The basis for the holdings of this Court which have upheld classification of business organizations for tax exempt purposes because they were mutual or cooperative organizations, is cogently stated in the dissenting Opinion in *Liggett Co. v. Lee* (immediately supra) and is upheld in the opinions of this Court which it cites, as follows:

> "... But Americans seeking escape from corporate domination have open to them under the Constitution another form of social and economic control—one more in keeping with our traditions and aspirations. They may prefer the way of cooperation, which leads directly to the freedom and the equality of opportunity which the Fourteenth Amendment aims to secure. That way is clearly open. For the fundamental difference between capitalistic enterprise and the cooperative—between economic absolutism and industrial democracy—is one which has been commonly accepted by legislatures and the courts as justifying discrimination in both regulation and taxation. *Liberty Warehouse Co. v. Burley Tobacco Growers Assn.*, 276 U.S. 71. Compare *Citizens Telephone Co. v. Fuller*, 229 U.S. 322." (at page 579).

Other cases in which this Court has upheld the classifications of tax exempt organizations on the basis of their

being a mutual or beneficial type, against attacks under the equal protection clause of the Fourteenth Amendment, are: *Northwestern Mutual Life Insurance Co. v. Wisconsin,* 247 U.S. 132, 140, 141 (1918), and *Louisville Gas & Electric Co. v. Coleman,* 277 U.S. 32 (1928). This latter is the case so heavily relied upon by Appellants herein; on the other hand, we submit that it is squarely contrary to their position and is squarely in point in support of Appellees' position (at pages 33 and 40).

This Court has recognized the fundamental difference, valid for classification for being exempt from taxes pursuant to the equal protection clause of the Fourteenth Amendment, as stated in *First National Bank of Shreveport v. Louisiana Tax Commission,* 289 U.S. 60 (1933) wherein the Court said:

> ". . . There is a fundamental difference between banks, which make loans mainly from money of depositors, and the other financial institutions, which make loans mainly from the money supplied otherwise than by deposits. Compare *Northwestern Mutual Life Ins. Co. v. Wisconsin,* 247 U.S. 132, 140-141; *Louisville Gas & Electric Co. v. Coleman,* 277 U.S. 32, 40." (at page 64).

The *source* of money used in a business is a valid basis for classification. The Texas Court found that all of Appellants "may borrow money for the purposes of financing small business concerns; . . ." (441 S.W.2d 251; Jurisdictional Statement, p. 47). This power to borrow money carries with it a very substantial difference between an open-end and a closed-end investment company, as stated by Appellants in their APPELLEES' BRIEF in the Texas Court of Civil Appeals, at page 37, as follows:

". . . There is an undeniable distinction between the two types of investment companies. An open-end investment company in theory is continuously required to sell or redeem its shares at the net asset value of its portfolio securities. Conversely, closed-end companies, such as the Appellees, have a relatively fixed amount of capital, and their shares are bought and sold in the market at market price. Since closed-end investment companies may engage in the practice of borrowing money for investment purposes (trading on the equity), they possess an inherent leverage factor which is not present in open-end companies. For this reason, in a closed-end investment company, the value of its shares does not necessarily equal the net asset value of its portfolio securities."

Accord: *Puget Sound Power & Light Co. v. Seattle,* 291 U.S. 619, 625 (1934).

The Congress of the United States, in the Federal Revenue Act of 1937 and the Revenue Act of 1938, classified and granted exemption from the Federal Income Tax to a "mutual investment company." Such a company was required to constantly redeem shares of its stock or their proportionate interest in the corporation's property, or for the cash equivalent thereof less a small discount. These two Acts of the Congress are discussed in the Opinion of the Texas Court at 441 S.W.2d 252 (Jurisdictional Statement, pp. 47-48). Each of Appellants acknowledge that they have neither redeemed nor offered to redeem any of their shares at any time.[3]

These provision of the Revenue Act of 1938 were

[3]Statement of Facts in the Trial Court at the following pages and lines: p. 65:4-18; p. 193:20-p. 197:21; p. 259:24-p. 260:24; p. 583:4-17; p. 502:5-15.

construed in the case of *New York Stocks, Inc. v. Commissioner of Internal Revenue,* 164 F.2d 75 (2d. Cir. 1947). This case is cited, discussed and quoted from in the Opinion of the Texas Court at 441 S.W.2d 252-253 (Jurisdictional Statement, pp. 49-52). We especially invite the Court's attention to a careful reading of this portion of the Opinion of the Texas Court.

POINT II
(Restated)

The purpose of the Texas Statute was to exempt from its franchise tax the type of corporation designated as, and having the well established characteristics of, a mutual investment company, and which corporation also should qualify under the additional five independent and mandatory requisites of the statute.

Statement

Whether a corporation is an open-end or closed-end company is only one of the many and severally independent requisites which the Texas Court has held to be required by the statute in order to qualify as a mutual investment company.

Argument and Authorities

The Texas Court held that in order for a corporation to be exempt from payment of the tax that it must *be* a mutual investment company (441 S.W.2d 250, Jurisdictional Statement, p. 45).

The Court found that each of Appellants lacked the requisite element of mutuality in its organization for the eight reasons enumerated by the Court (441 S.W.2d 257-258, Jurisdictional Statement, pp. 62-64). The

Court's holdings are further documented and sustained by 1) the multiple decisions of this Court and the Circuit Court and the Acts of Congress, all of which are presented under POINT ONE of this MOTION, 2) the historical basis of the mutual concept as exemplified by other Texas statutes (441 S.W.2d 254-255, Jurisdictional Statement, pp. 54-56), and 3) the meaning of terms used in the securities field and in related Acts (441 S.W.2d 258-261, Jurisdictional Statement, pp. 64-70).

In addition, the Court made express holdings that each of Appellants, in the manner of the operation of its business, failed to qualify as a mutual investment company in the following respects:

1) Each was organized and licensed as a small business investment Company (441 S.W.2d 257, 263-265; Jurisdictional Statement, pp. 61,77-81);

2) The securities held are not characteristic of those commonly held by mutual investment companies (441 S.W.2d 265; Jurisdictional Statement, pp. 81-83);

3) The rights of shareholders in the assets of the Appellant companies are not in the investments they make and are not of the mutual kind (441 S.W.2d 265-266; Jurisdictional Statement, pp. 83-84);

4) The payment of earnings had not been on any kind of regular basis (441 S.W.2d 257; Jurisdictional Statement, pp. 61-62);

5) Each of Appellants is controlled by large shareholders (441 S.W.2d 266, Jurisdictional Statement, p. 84);

6) Each of Appellants has received substantial in-

come from the rendition of management, financial and advisory services or as closing and commitment fees (441 S.W.2d 266-267, Jurisdictional Statement, pp. 85-86);

7) One of the principle business objectives of each of Appellants is to realize income through stock options and conversions thereof (441 S.W.2d 267; Jurisdictional Statement, pp. 86-88);

8) Each of Appellants has exercised controlling influence over the management and policies of their portfolio companies (441 S.W.2d 268; Jurisdictional Statement, pp. 88-91).

By way of summary under this POINT TWO, none of Appellants has manifested any color of mutuality in either its organization or mode of operation.

POINT III
(Restated)

Requisites Numbers three, four and five of the statute, as enumerated by the Texas Court, were not complied with by any of Appellants. Each is wholly unrelated to whether any Appellant was an open-end or a closed-end company.

Statement

Each of the six requirements of the statute is independent from all others and equally mandatory. The judgment of the Texas Court may rest upon any one or more of them. Each of the requirements numbers three, four and five, severally, constitute an adequate non-federal basis to support the judgment.

Argument and Authorities

The judgment of the Texas Court may be independently supported by its holding relative to each, sever-

ally, of the requirements of the Texas statute designated as requirements numbers three, four and five (441 S.W.2d 250-251; Jurisdictional Statement, p. 45). Each of these is independent of the other, each is wholly unrelated to whether any Appellant was an open or closed-end company, and each such requirement is a non-severable and mandatory requirement of the Texas Statute. The judgment is fully supported upon each of these non-federal grounds.

Requirement No. Three is that an exempt corporation shall "hold stocks, bonds, or other securities of other companies solely for mutual investment purposes." Instead, the Court found that each of Appellants had exercised control over their portfolio companies and that one of the principle business objectives of each of Appellants was to realize income through stock options and their conversions (441 S.W.2d 267-268; Jurisdictional Statement, pp. 86-91).

Requirement No. Four of the Texas statute is that an exempt corporation must "receive its sole source of income from dividends or interest on stocks, bonds, or other securities of other corporations (held solely for investment purposes)." Contrary to this requirement, each of Appellants received fees for services in the nature of management, financial and advisory services (441 S.W.2d 266-267; Jurisdictional Statement, pp. 85-86); each of Appellants received fees denominated closing and commitment fees (441 S.W.2d 267; Jurisdictional Statement, p. 86); and each has received, as one of its principle business objectives, income through stock options, and their conversions (441 S.W.2d 267; Jurisdictional Statement, pp. 86-88).

Requirement No. Five of the Texas statute is that

an exempt corporation must "hold stocks, bonds, or other securities of only those corporations which are subject to and pay a franchise tax." Appellants' failure to comply with this requirement leaves wholly unsupported their claim that they have been subjected to double taxation. (441 S.W.2d 262-263; Jurisdictional Statement, pp. 74-76).

CONCLUSION

WHEREFORE, Appellees respectfully submit that the questions upon which this appeal is predicated are so unsubstantial as not to need further argument and that the judgment of the Texas Court rests on many adequate non-federal bases. Appellants respectfully move the Court to dismiss this appeal or, in the alternative, to affirm the judgment by the Court of Civil Appeals for the Third Supreme Judicial District of Texas.

Respectfully submitted;

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Jesse James, State Treasurer of Texas, and

Crawford C. Martin, Attorney General of Texas.

APPENDIX A

DENIALS OF STATEMENTS IN APPELLANTS' JURISDICTIONAL STATEMENT

The following statements of purported facts at the following pages of Appellants' Jurisdictional Statement are denied because they are wholly contrary to both the record and the opinion of the Court below:

1) At page 15:

> "It is undisputed that at all material times each of the Appellants was an investment company registered under the Federal Investment Company Act of 1940 *which held stocks, bonds and other securities of other companies solely for mutual investment purposes. . . .*" (emphasis added).

The underscored language is categorically denied; both the record and the opinion of the Texas Court refute this statement of fact.

2) At page 29:

> "It is a matter of common knowledge that the five open-end investment companies which have been granted an exemption derive their greatest amount of income from realized appreciation of their portfolios."

3) At page 31:

> "Both the Appellants and Appellees agree that in 1951 at the time of the enactment of the exemption in question, there was no common definition of the term 'mutual investment company.' (441 S.W.2d at 252) . . ."

The four authorities in complete refutation of this misstatement of fact, the Federal Revenue Act of 1937

and the Revenue Act of 1938, the case of *New York Stocks, Inc. v. Commissioner of Internal Revenue,* 164 F.2d 75 (2d Cir. 1947) and Websters Third New International Dictionary, are cited and discussed by the Court (441 S.W.2d 252-253; Jurisdictional Statement, pp. 48-52).

APPENDIX B

TYPOGRAPHICAL ERRORS IN JURISDICTIONAL STATEMENT OF APPELLANTS

The following tyopograhical errors appear in Appellants' Jurisdictional Statement, as follows:

1) At page 54, the word whose has been omitted from the beginning of the fourth line from the top of the page.

2) At page 57, the fifth line, the style of the case cited as *St. Regis Candles, Inc. v. Hovas* should be *St. Regis Candies, Inc. v. Hovas;*

3) At page 57, in the ninth line, the style of the case cited as *Ferguson v. Meredith,* should be *Clearwater v. Meredith.*

CERTIFICATE OF SERVICE

I, William Edward Allen, Assistant Attorney General of Texas, certify that a copy of the foregoing Motion to Dismiss or Affirm was served on the Attorneys for Appellants, by depositing same in the United States Mail, first class postage prepaid, certified mail, addressed to the following attorneys of record for Appellants:

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all having been so mailed on the ____ day of February, 1970.

I do further certify that copies of the Jurisdictional Statement filed by Appellants in this No. 1130 were received by Attorneys for Appellees on January 30, 1970.

WILLIAM EDWARD ALLEN
Assistant Attorney General